INFLATION
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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

The UK Strategy Against Inflation

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
1 May 1971

INTELLIGENCE MEMORANDUM

THE UK STRATEGY AGAINST INFLATION

Introduction

1. In the postwar era the British have tended to attach greater priority to maintaining high employment levels and defending the sterling exchange rate than they have to other national economic goals. Thus, through most of the 1960s the economy's bellwethers were the balance of payments and the unemployment rate. Now, following large international payments surpluses in 1969 and 1970 and a 75% reduction (since 1969's high) in outstanding medium- and short-term debts to other nations (excluding liabilities within the sterling area). UK policymakers have been occupied more by the inflation issue. Particularly rapid wage gains and slow productivity growth since late 1969 have reduced both the comparative gains from the November 1967 devaluation and the relative profitability of exporting. Concern for declining international competitiveness and accelerating inflation have inhibited stimulation of economic growth.

2. This memorandum traces incomes policies since devaluation, analyzes the 1969-70 wage explosion, and describes London's options in coping with inflation. The government's emerging game plan to deal with inflation is outlined, and the longer run implications of sustained inflation are considered.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

Discussion

Prelude to Inflation

3. The sterling devaluation of November 1967 had the potential of unleashing rapid and continuing price rises within the British economy. Increased export profits – an acknowledged devaluation goal – were to boost incomes without significantly affecting real output for domestic uses in the short run. Additional inflationary pressure would result from higher sterling prices for imports of raw materials and intermediate goods. To avoid inflation and to direct resources toward investment and production for export, the government introduced a series of contractionary monetary and fiscal measures between November 1967 and March 1968. An incomes policy, 1/ formed during the early days of the Labor government in 1964, was reformulated for the third time in early 1968 to protect the export price improvement obtained through devaluation. It was hoped that this would help preserve British competitiveness and avert international payments problems, thereby avoiding the "stop-go" cycles that had slowed growth and dampened investment plans.

Incomes Policy After Devaluation

4. The March 1968 announcement of a 3.5% targeted ceiling for annual wage and dividend increases set the stage for the Labor government's post-devaluation incomes strategy. This ceiling, applicable through 1969, was based on projections of the long-run rate of growth of productivity. The government would refer new price and wage demands to the National Board for Prices and Incomes (PIB), which could recommend a delay of up to 12 months.

5. This goal was clearly unrealistic. Following a 16.7% devaluation 2/ and substantial increases in indirect taxes, it implied a substantial decline in real wages because of greater sterling import costs

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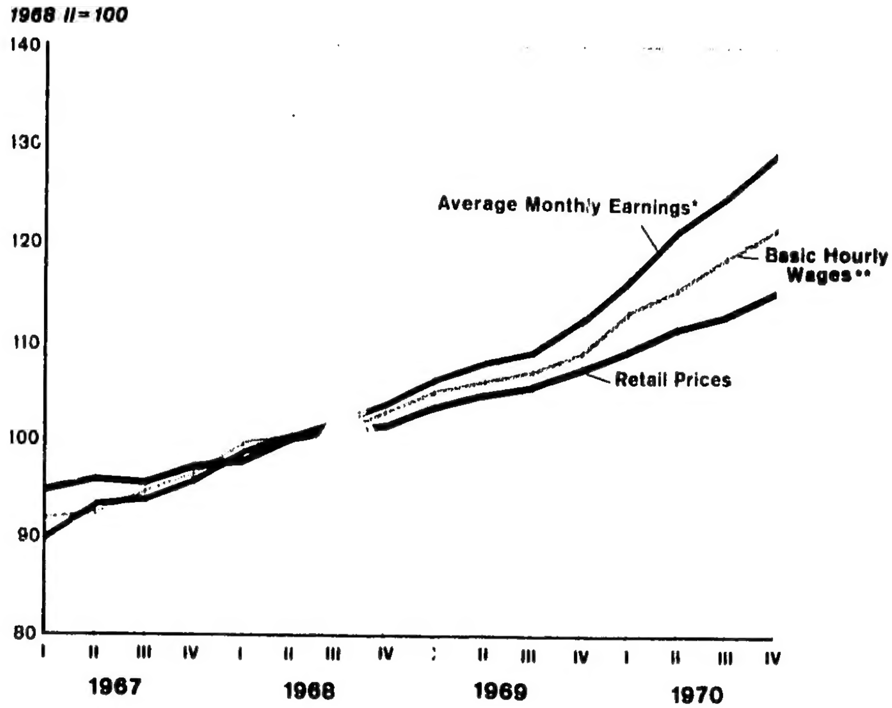
1. *As used in this memorandum,* incomes policy *refers to the combination of government measures designed to assure that the rise in money incomes does not exceed the long-run rate of growth in national output. Most prominent among these measures has been a wages policy, the execution of which has been as strong as a wage freeze (mid-1966 -- mid-1967) and as week as guidelines (for example, in 1965).*

2. *Although the devaluation is more commonly described as one of 14.3% in terms of new and old export values, the potential increase in import prices was 16.7%.*

and higher prices for a range of domestically produced goods. In the event, basic hourly wages grew 5%-6% and average monthly earnings over 7% in the year following the March incomes announcement (see Figure 1). With retail prices up about 6%, this meant that real wages were essentially unchanged.

Figure 1

UNITED KINGDOM: Wage and Price Movements



*Manufacturing, men only
**Manufacturing, all employees. Fragmentary data indicate that the wage drift was higher than inferred by this graph because womens average earnings grew more slowly than those of men.

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6. Holding real wages nearly constant was a fair achievement considering the political realities confronting the Labor government. Labor had used up much of its political capital by imposing an incomes and price

freeze 3/ from mid-1966 through mid-1967 to avoid a devaluation. The freeze was followed by a catch-up period between mid-1967 and early 1968 in which wages soared at an annual rate of nearly 12% – just at the time when devaluation occurred anyway.

7. In this climate of growing hostility toward wage guidelines, organized labor exerted considerable pressure on the parliamentary Labor Party to justify wage gains of more than 3.5% annually. The principal face-saving device was a stipulation that bonuses could be allowed for "unusual" productivity gains. In many instances, these bonuses were provided in contracts in which most of the wage increase came in the first year and the productivity "gains" were simply targets for later years.

<u>The Death of Incomes Policy</u>

8. In 1969, following a spring slowdown, the size of initial pay demands and the rate of increase of wages picked up rapidly toward yearend. This reflected, in part, an increasing public awareness that the Labor government was willing to sacrifice its incomes targets for other objectives. Thus, in April, the government made it clear that it would allow its delaying powers to lapse in December if organized labor cooperated in passing a major labor relations bill. [redacted] 25X6

25X6 The government's retreat was clear when the teeth of the labor relations bill – clauses providing for financial penalties for strikers – were pulled by the unions and the bill itself withdrawn in June 1969.

9. The statutory provision for 12-month price and wage delays lapsed in December 1969, but the government mustered party discipline to sustain a four-month delaying power enacted in 1966. At the same time as this minor victory, wages in manufacturing industries rose 4.1% for the month. With the 1970 election at hand, talk of wage restraints quickly died out. The Conservatives, elected in June on a platform emphasizing reducing the government's economic role, made plain their contempt for formal incomes planning and guidelines. The PIB was to be abolished on 31 March 1971 and its remaining functions transferred to other government components.

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3. The wage freeze, which was supported by compulsive and punitive measures, was modified somewhat at the outset of 1967. Nevertheless, the index of wages for all industries and services increased only about 2.7% and earnings 1.0% for the period.

Related Government Economic Policies

10. Measures accompanying and following the 1967 devaluation were not necessarily well-coordinated with incomes policy or each other. In part, this was because devaluation had been precipitously forced on a reluctant Labor government, with very little time for medium-range planning. But the timing of later tax measures was also off. Further complicating coordination was the long-standing Bank of England commitment to support the prices of government's "gilt-edged" bonds, the market for which tended to rise and fall with movements in Britain's international payments and debts. 4/ These support activities often raised the money supply by increasing bank reserves and lending at the wrong times. Finally, staunch efforts to avoid further runs on sterling made for a relatively inflexible defense of particular exchange rates within the official margins.

11. The major results of these assorted complications during 1968-69 were perverse increases in consumption and erratic movements in the money supply. Thus, following the devaluation, the nature of government statements on reduced expenditure levels for the fiscal year beginning on 1 April 1968 also made it clear that indirect taxes would probably be raised. 5/ The lag from November to April in effecting indirect tax increases and the abnormal wage gains that followed the 1966-67 wage freeze combined to produce a consumption boom. This boom proceeded full-steam through mid-1968. Another unfortunate gain in consumption occurred in November 1968, when increases in certain manufacturers' sales taxes were announced, yet could not begin to work their way through to retail sales for a matter of months. 6/ Such concentrations of consumer demand in

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4. The domestic consequences of an international loss of confidence in sterling typically were: (1) sales of gilt-edged bonds by foreign and then domestic holders; (2) Bank of England purchases to support the price; and (3) a resulting increase in the money supply that subsequently had to be offset by constraints on domestic credit to protect the balance of payments. Thus the primary domestic effect was to undermine the timing of monetary measures in relation to domestic goals.

5. The heavy reliance since devaluation on the "regulator," the primary instrument of discretionary changes in indirect taxes, raises basic conceptual problems, for fiscal theory emphasizes that such tax increases tend to raise the general price level. Further increases in direct taxes -- which are already extremely high -- are, however, much more difficult to obtain.

6. Thus, two lags have tended to complicate the use of indirect taxes levied at the manufacturers' stage. The first -- a lag in implementing a policy decision -- spurred consumption in early 1968. The second -- a lag in impact on retail sales -- temporarily spurred consumption in the holiday season of December 1968. A national retail sales tax would not have suffered the second lag.

anticipation of tax increases tended to bid up retail prices rapidly at particular periods, and the combination of subsequent indirect tax effects and oligopolistic pricing kept them up. This spurred still higher wage demands to cover cost-of-living increases.

12. Changes in the money supply also seemed to work at cross-purposes to wage and price restraint largely because of the Bank of England's focus on the gilt-edged market. The average level of the money stock increased at an above-average rate of 6% in 1968 (a year of a serious deficit in international payments) and less than 1% in 1969 (when there was a basic international payments surplus of about $1 billion). Quarterly movements in some instances were even less well coordinated to incomes objectives. Thus, even on a seasonally adjusted basis, the most rapid growth in the money supply during 1968 occurred in the second and fourth quarters, when public pressure to raise wages to offset the effect of devaluation and higher taxes were particularly strong. Again in 1969, substantial inflows of funds from abroad permitted an expansion of the money supply in the last quarter 7/ to help support a wage boom then under way.

The Wage Inflation of 1969-70

13. The erosion of the political basis of an active incomes policy and the occasionally conflicting applications of fiscal or monetary policies set the stage for rapid wage and price gains in 1969-70. Further complicating attempts at wage and price restraint was the need to marshall Labor Party unity for an anticipated close victory in the June 1970 elections. The Conservative upset put in power men to whom an explicit incomes policy was anathema and whose sights were fixed on long-run economic goals such as a reduced government role in the economy, fundamental changes in industrial labor relations, 8/ and accession to the European Communities (EC). Not surprisingly, their first encounters with wage demands were not notably successful, and an implicit incomes policy only began to take shape by yearend.

7. *As in other periods, the Bank of England failed to take full advantage of the opportunity to sell gilt-edged bonds to offset the expansion.*

8. *A long-awaited Conservative industrial relations bill was introduced in Parliament on 3 December 1970. The bill is directed at broadening the legal reference for union activities and curbing wildcat strikes, which have been a particular difficulty in the United Kingdom. Financial penalties are provided for acts defined as "unfair labor practices." In addition, the bill would create a national registry for unions and tend to penalize those unions that did not register. Closed shops would be outlawed in all but a few instances. The bill – which is through Commons – is expected to pass the House of Lords and become law this summer, but creation of all its institutional features will require nearly another year.*

The Nature of the Inflation

14. Although it is always hazardous to specify that wage increases have caused an inflation, the course of British incomes, prices, and profits since late 1969 strongly suggests this conclusion. Between the last quarters of 1969 and 1970, basic hourly wages for all industries rose 13.0%, while the corresponding retail price increase trailed at 7.7%. In the manufacturing sector alone, men's wages went up 11.7%, and together basic wage increases and wage drift led to gains in average earnings of 14.8% (see Figure 1).

15. Two equally disconcerting indicators over the period were the growing size of new wage demands and their recurrence in the same industries after rather short periods. Thus, during 1970, most initial pay demands moved up from increases well below 20% to ones significantly higher. At the same time, little attention was paid to the fundamental precept of incomes policy that no more than one pay increase in relation to any particular job should occur in a 12-month period. Indeed, more than one-third of the nationally negotiated settlements in the first half of 1970 followed comparable settlements by less than a year. 9/

16. A striking feature of the recent wage-push inflation has been the tenacity – and success – with which unions pressed demands despite growing unemployment. From mid-1969 through 1970, unemployment rose from 2.2% to 2.6% 10/ (see Figure 2). Indeed, for the whole period since devaluation, unemployment has been considerably above the 1.6% of 1959-66, but wages have trended upward faster than for the earlier period. This pattern doubtless reflects increased unemployment benefits on the one hand and rising wage aspirations on the other.

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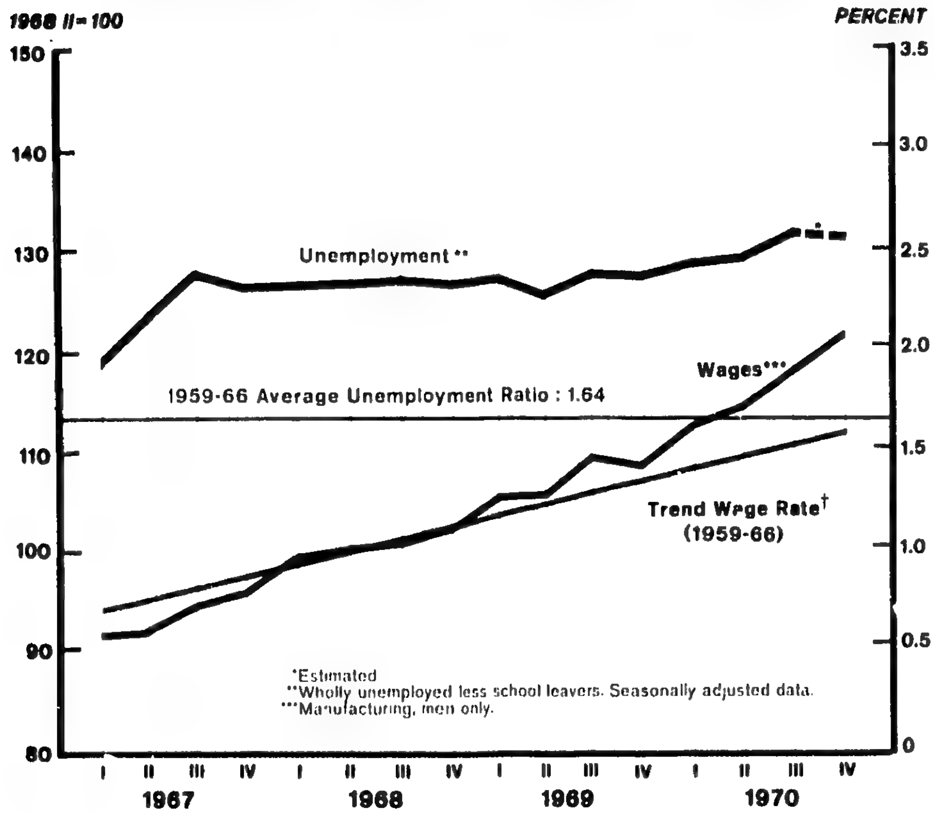
9. Interestingly, about half the cases of two settlements in a year were in the public sector.

10. In general, unemployment levels in the last three quarters of 1970 were worse than those for any year since 1940. This pattern persisted into the first quarter of 1971, when unemployment rose to 2.8%. By April the monthly estimate (seasonally adjusted) was up to 3.1%

Figure 2

UNITED KINGDOM: Wage and Unemployment Patterns



† *Derived using quarterly data and Least Squares Method.*

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17. Combined with a generally slower growth of labor productivity than in other industrial countries, the rapid growth of British wages in 1968-69 and their acceleration in 1970 meant a serious depletion of the broader competitive gains from devaluation. Increases in unit labor costs in the United Kingdom were substantially greater than for its competitors, as shown below for the third quarter of 1970.

	First Quarter 1968 = 100	
	Export Prices a/	Unit Labor Costs a/
United Kingdom	113	11[illegible]
Competitors' index (overall)	111	110
United States	111	108
West Germany	114 b/	121 b/
Japan	107	101

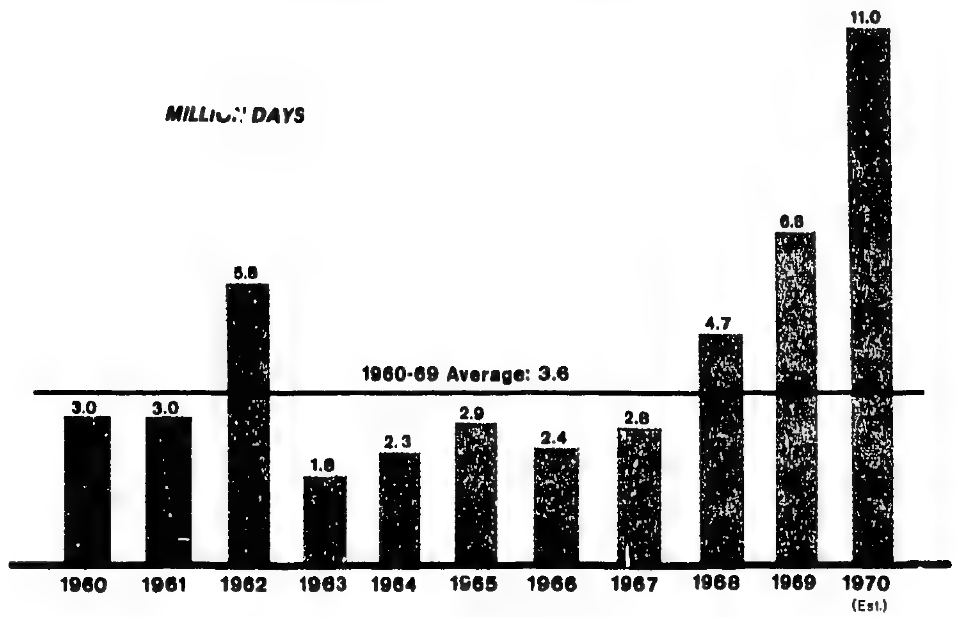
a. Data computed on a dollar basis.
b. Including effects of 9.3% revaluation of the mark in October 1969.

18. The salutary effects of the 1967 devaluation are now essentially exhausted because: (1) it reduced the dollar value of UK labor costs about 8% relative to those of its competitors; and (2) UK labor costs since then have increased about 8% more than those of its competitors. The loss of this competitive edge has not yet been reflected in the volume of exports. However, exports are bound to be hurt in the longer term. The need to maintain competitive prices has seriously squeezed UK exporters' profits, thereby discouraging export activities and undermining related investments. Those facets of competitiveness that must be continually supported by investment are critical to the United Kingdom, whose most important exports are engineering goods. This is so because such goods are classically sold in markets where advertising, attractive delivery times, a reputation for dependability, and effective after-sales service are fully as important as price criteria.

19. If the price/cost consequences of wage escalation are likely to prove inimical to the British balance of payments, the increasing unrest among laborers that has accompanied the death of an active incomes policy is even more dangerous. Delivery schedules for the home and export markets in 1970 were seriously affected by numerous and sustained strikes in the engineering industries and by a three-week dock strike in July-August. All told, the loss of worktime to strikes in all industries and services last year reached 11 million working days (see Figure 3), the highest level since the unusual general-strike year of 1926. Besides the obvious immediate consequences for production and exports, such strike losses make the British economy a particularly unreliable source of intermediate goods and capital equipment. This fact has seriously dampened the interests of overseas

Figure 3

UNITED KINGDOM: Loss of Worktime to Strikes*



*Data exclude stoppages involving fewer than ten workers or one day unless a total loss of worktime of 100 days is involved.

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investors in establishing or expanding production facilities in the United Kingdom, 11/ thereby discouraging needed long-term capital inflows.

Financing Wage Inflation

20. The surge in wages beginning in late 1969 was financed largely by reducing company profits, although there was an accommodating spurt

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11. A notable instance is Ford Motor Company, which is reported to be actively planning cutbacks in its British operations and announced in late February 1971 that it had decided against the United Kingdom as a site for a $72 million engine plant. Ford has been estimated to have invested as much in the last 10 years in the British auto industry as the rest of the automotive firms put together.

in the money supply in the second and third quarters of 1970. A variety of indicators showed a decline in real private-sector profits after the third quarter of 1969, but the redistribution in factor returns is most easily shown in relation to national income. As can be seen in the table, employment income has risen from the 67.6% of total domestic income characteristic of 1959-66 to 71.1% in the third quarter of 1970. For the same periods, the gross trading profits of private companies have fallen from 15% to 11.4% of domestic income. This was already a long-term trend, but it accelerated during 1970. Moreover it was probably accentuated late in the year and in early 1971, when monetary policy was significantly tightened.

21. The predictable consequence has been a reduced capability to finance expansion from companies' own funds. This – compounded with tight money markets, the slow growth of the economy, and dimmed export prospects – has meant a projected decline in fixed investment for 1971. This was already apparent as new machine tool orders for the home market dipped sharply in the fourth quarter of 1970. It is hard to imagine how the rate of increase of British labor productivity can be significantly enhanced in these circumstances.

The Emerging Game Plan

22. A review of the constraints under which the British government framed its policies toward wages and prices in 1970-71 provides no grounds for easy criticism. The surge in the supply of money and bank advances under the Labor government in the second and third quarters of 1970 imposed upon the Conservatives an immediate requirement for tighter-than-usual monetary policy. Moreover, this restraint had to be undertaken in the face of an international interest-rate differential that significantly favored the United Kingdom and thereby stimulated inflationary capital inflows. Popular attitudes with respect to growth and inflation were also serious handicaps. Growing impatience with unusually high unemployment, slackening investment plans, and two successive years of slow growth made monetary and fiscal restraint severe political liabilities. Wage earners tended to address their efforts toward "doing one better" on the most recently announced agreements, and an unending wage-price spiral was generally accepted as inevitable. Further complicating the ultimate achievement of a counter-inflationary mood throughout the economy was the fact that earlier wage gains had not yet worked their way through to higher prices.

23. Difficult as these constraints have proved, they are nowhere near as exacting as the tightropes that must be walked in dealing with labor and management separately. If the pervasive inflationary psychology is to be broken and the process of passing the proposed industrial relations bill

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British Wage and Profit Shares in Domestic Income a/

Percent b/

				1969				1970		
	1959-66	1967	1968	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	1st Qtr	2nd Qtr	3rd Qtr
Income from employment	67.6	68.5	68.2	69.0	69.2	68.8	69.5	70.0	70.5	71.1
Gross trading profits of private-sector companies	15.0	13.4	13.5	12.5	12.5	12.9	12.5	12.0	11.6	11.4
Other factor incomes	17.4	18.1	18.3	18.5	18.3	18.3	18.0	18.0	17.9	17.5
Total domestic income	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*

a. No provision is made for stock appreciation.
b. Based on seasonally adjusted data.

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is not to cost large losses of worktime throughout 1971, it is necessary for government spokesmen to maintain a meaningful dialogue with organized labor. This has proved extremely difficult because: (1) there is an historic distrust toward Conservatives among labor unionists; (2) recent settlements have provided high benchmarks for subsequent "leapfrogging;" and (3) wage demands have so clearly exceeded levels that would be acceptable to any British government. Management has proved only slightly more tractable, despite its traditional good will toward the Conservatives. The squeeze on corporate liquidity through the first quarter of 1971 that vexed managers was generally seen by the government – at least in the short run – as an advantage, for it was likely to stiffen private-sector resistance to wage demands. To avert the direct translation of wage gains into price increases continues to require a blend of reliance on competitive forces and arm-twisting. At the same time, the government has to reply to arguments from manufacturers – including particularly those who export – that wage increases are generally preferable to strikes and redeveloping lost markets.

24. Despite the challenge of developing a strategy against inflation within these constraints, there has been no dearth of suggestions for "simple" solutions. Among the suggestions incorporating particularly broad economic measures have been proposals for: (1) another devaluation; and/or (2) more explicit and consistent targets for changes in the supply of money. Although devaluation – which may ultimately prove necessary in relation to EC accession (or later monetary union) – would again enhance the UK's comparative costs, it would also probably exacerbate the present wage-push inflation. The latter proposal – reflecting increasing concern for the rate of growth of the money supply – already characterizes British monetary policy. This particular nostrum, however, entails recognition that (1) monetary measures are almost certain to result in increased unemployment before the wage-price spiral is broken; and (2) even reductions in the money supply affect the economy with a considerable lag.

25. Other cure-alls proposed as inflation strategies have included the delineation of an explicit incomes policy (complete with targets), a wage freeze, and a price freeze. Given the decay of Labor's explicit incomes policy and the lack of consensus between the Conservatives and organized labor, it is hard to imagine how a meaningful and credible set of targets could be contrived from the opposing views of management and workers. 12/ Objections to the concept of a wage freeze hark back to the experience of 1967 to point out that it would probably be followed by an explosive

12. The difficulties notwithstanding, the Confederation of British Industries and the Trades Union Congress were engaged in secret exploratory talks on the possibility of a voluntary incomes policy in mid-April 1971. At the time, the government remained aloof from the discussions.

make-up session, which could prove quite detrimental to the UK's balance of payments a year or two hence. The price freeze is the most subtle of the numerous suggestions, for it focuses its effects directly on today's bargaining process. With prices frozen and liquid assets still at unusually low levels, private-sector companies would be forced to hold the line against wage demands or go under. It is less clear that public-sector enterprises would behave as well, for their access to credit is generally better. Moreover, those in the private sector who had been slowest in the past in passing on wage gains would suffer proportionately more as the freeze was invoked.

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25X6 [redacted] Substantial consideration had been given to withdrawing government from unprofitable economic enterprises and to encouraging increased competitiveness in the private sector. Similarly, Prime Minister Heath has repeatedly made it very plain that reform of industrial relations was necessary to reduce the incidence of costly wildcat strikes. But none of these goals pertained directly to reducing the rate of wage and price gains in 1970-71.

27. After a number of false starts and stiffening government resistance toward wage demands, the game plan of the Conservatives began to take shape in late 1970 and was substantially refined in the budget message of 30 March 1971. The key elements have been: (1) developing monetary and fiscal policies designed to limit the growth of demand to the historic rate of growth in productive potential; (2) using wage settlements in the public sector as examples of managerial restraint against wage demands; and (3) arm-twisting of firms in the private sector that face major wage disputes. Even in the short period since the Conservative electoral victory, there have been substantial changes in monetary policy within the broad guideline of restraint. Thus, offsetting abnormally rapid growth in the money supply in mid-1970 required a November 1970 call for increased special deposits and a January 1971 restriction of domestic uses of short-term capital inflows. By late March, however, a new guideline was announced for quarterly growth in bank advances at a little more than double the 1970 rate. 13/ The longer term thrust of fiscal policy became evident in tax changes in October 1970 and a March 1971 budget, both of which sought to allow increased retention of corporate funds to support

13. On 1 April the bank rate (that is, the discount rate) was lowered by one point from 7% to 6%, but this move was motivated as much by a desire to keep in step with financial developments abroad as by domestic considerations.

a higher rate of manufacturing investment and – thereby – a more rapid rate of growth and increases in employment. The coordination of fiscal and incomes policies in the short run is decidedly less clear, for the new budget will facilitate increased consumption in a period of rapidly rising wages. The nature of the wage objectives was revealed by: (1) "trial balloons" on 8%-11.5% guidelines for early 1971 leading to a yearend target of 7%; and (2) the emergence of the "n-1" rule. The latter approach looks for reductions of one percentage point in the sizes of successive settlements. Arm-twisting and consultation are invoked with some regularity in the hope that they will carry the public-sector norms – or better – over to the private sector.

28. The clearest and most immediate measure of the government's resolve in facing down inflationary actions has been its behavior in public-sector settlements since its election in June 1970. Early, rather disorganized efforts at indirect influence in respect to local authority manual workers (September/November) and coal miners (October/November) ended in distinctly inflationary wages increases of 18%-20% and 12%, respectively. A much tougher line toward electric utility workers resulted in a December power strike that cost the unions considerable loss of public sympathy and led to pay settlement through a court of inquiry. Unfortunately, the force of government efforts was blunted in this instance by a February court finding advertised by the government as a 10.9% increase in average earnings and generally recognized by the public to reach nearer 20% when bonus schemes and various sweeteners were included. Nevertheless, hearings by such a court, which was under instruction to consider "the interests of the public and of the national economy," temporarily supplanted the monotonous national pattern of strikes and capitulation and provided a useful vent for government views on appropriate wage and productivity increases. The courage found in the initial rounds with the power workers was sustained in a 47-day strike of postal employees. In this case, referral to a committee of settlement in early March came after the union had reduced its initial wage demand from an increase of 15% to one of 13% and government had remained essentially unmoved from an initial offer of 8%. At about the same time, a settlement was reached with some 140,000 civil servants, who received raises ranging from 9.5%-13.0%. Still treading a path between the private sector's highs and its own targets, public-sector management made a firm final offer of 8.8%-11.0% wage increases to 196,000 railwaymen in mid-April.

29. The weakest link in the government's strategy against inflation is potentially that of obtaining corporate managerial response to public-sector demonstrations of restraint. Given the spotty incomes record of the new government thus far, it is amazing that the private sector has indeed shown scattered signs of rallying. The public was quite cooperative in enduring the postal strike, and numerous entrepreneurs acted in that

case to provide substitute services. Earlier, in January, concern over the possible outcome of a wage demand at a British Leyland automotive plant in Scotland (where unemployment runs substantially higher than the national average) had led to a six-month voluntary wage freeze and thereby provided the government with a prized example that its program was beginning to have some impact. That a counter-inflationary psychology was beginning to take hold with private management was evident in a decline in January 1971 for the first time in 15 months in the forecast of cost increases cited in the *Financial Times* "Monthly Survey of Business Opinion." This impression was strengthened by commentary in *The Economist* in late March on a leveling-off of wage increases at 12% and by observations in the press in April that new wage demands were down to the 12%-15% range from 1970's characteristic 20% and more. Nevertheless, the conclusion in early April of a strike against Ford Motor Company with a pay settlement incorporating 15%-18% increases in the first year and 8%-9% increases in the second year posed an unfortunate challenge for subsequent union negotiators. 14/

The Outlook for 1971

30. The irrefutable facts of the 1969-71 wage explosion are that price increases have lagged behind wage gains and that each of the wage settlements continues to exceed prospective productivity gains by a wide margin. Combined with depleted corporate funds, these facts spell accelerating unit cost and price increases for much of 1971 irrespective of any forthcoming government victories in the wages battle. A surge in retail prices in the first quarter of 1971 was symbolic of things to come. Although this particular rise probably owed a little to "rounding up" for new decimalized prices, the year-to-year gain over the first quarter of 1970 was a sizable 8.6%. Of increasing concern is the size and basis of the 7.6%-8.4% 15/ increase in the wholesale price index for manufacturers' home sales between the last quarters of 1969 and 1970. This gain in wholesale prices took place despite very little corresponding change in the prices of related raw material and fuel inputs. 16/ Rising prices of crude oil and raw materials, the end of a deficiency-payments system in agriculture, and some further adjustments to decimalization will all add to the basic wage push this year to keep prices soaring. The real question

14. At about the same time, Vauxhall, another firm in the automotive industry, reinforced the adverse effects of the Ford settlement by offering a 28% pay hike spread over 17 months.

15. The upper end of the rage excludes products of food, drink, and tobacco manufacturing industries.

16. For all manufacturing industries, material and fuel inputs rose 2.3% in price; excluding food industries, there was a 0.1% decline.

for the government is whether the pervasive inflationary psychology can be broken promptly to halt further hedging against price increases in wage demands, thereby slowing inflation toward yearend.

31. Further complicating the goal of achieving a slowdown in prices and wage gains has been the groundswell of public opinion in favor of immediate reflation to reduce unemployment. 17/ The budget announced on 30 March provides a modest first-round stimulus of about £250 million ($600 million) to aggregate demand. Although this superficially appears far short of the £500 million "initial" stimulus called for by the prestigious National Institute of Social and Economic Research, 18/ the budget contemplates and supports an increase of 5.3% in consumption (as compared with 2.8% and 3.3% in the preceding fiscal years). In contrast, both fiscal and monetary policies have been framed to *permit* a gain of about 0.5% in private fixed investment during the fiscal year 1971/72. The objective of an expansionary budget is to get quick gains in output and productivity, 19/ thereby moderating the rise in unit costs. At the same time, however, the fiscal (and monetary) stimulus will make it easier for the private sector to finance higher wages and will also contribute to inflation by raising consumer demand.

32. Because of the complexity of wage and fiscal developments and the heavy dependence of the rate of inflation on psychological factors, it is quite risky to project cost/price movements for 1971. In November 1970 the Organization for Economic Cooperation and Development (OECD) projected slowdowns in the UK's annual rates of growth in average earnings to 12% and wage rates to 10% by the second half of 1971, but both these projections were based on under-estimates of the 1970 pay gains. As indicated above, the government speculated in January about the possibilities of attaining a 7% annual rate of wage increases by yearend and an 11% rise in earnings for the year (compared to 14%-15% for 1970). Ironically, these figures were trotted out at the court of inquiry into the electric power settlement, which eventuated in earnings increases close to 20%. For the moment, it is safe to say that the annual rate of increase in retail prices is on its way up past 10% and that it may be some months before the corresponding increase rate for wages falls below that. Thus it is quite possible that the annual increase for 1971 for both retail prices

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17. See footnote to paragraph 16.

18. The difference in the two positions is narrowed by the fact that the new budget includes tax payments for 1970/71 that were not actually collected until 1971/72 because of the postal strike.

19. Were unemployment lower and industrial capacity utilization higher, the productivity gains would not be possible. It remains to be seen if the government's judgment about existing slack is correct.

and wages will be about 10% and that workers' earnings will rise somewhat more. Even this rather alarming prospect will depend in no small measure on sustained, energetic efforts of the government to face down wage demands. Failing this, there will probably be need to resort to a wage and/or price freeze and to a substantial further increase in unemployment.

33. The implications of sustained inflation in the United Kingdom for 1971 are plain. Although the UK economy is currently running at less than its potential growth, the present inflation will allow only very limited and cautious use of reflationary measures this year. International prospects are no more encouraging. Few – if any – other industrial countries will experience comparable increases in costs and prices in 1971, and British export competitiveness will likely sink to below the pre-devaluation levels. For the early part of 1971, however, the adverse effects on the UK's export volume will likely be offset by increased export prices. The declining competitiveness will show in a substantially worsened trade balance toward yearend. Moreover, traditional market positions and export opportunities will suffer further as wage battles and political strikes over the industrial relations bill occasion even more losses to worktime than in 1970. 20/

Long-Run Implications of British Inflation

34. Continued rapid inflation will inhibit Conservative strategies to effect structural changes in the slow-growing British economy. The economic policies necessary to function in an atmosphere of rapid wage and price increases will often conflict with those likely to facilitate private initiatives and a smooth entry into the EC. In particular, sustained inflation will hobble the Conservative government in: (1) devising policies for faster economic growth; (2) defending sterling and covering international economic requirements; and (3) holding the party's present political base.

35. The need in the face of sustained inflation to restrict the growth in demand through fiscal and monetary restraints will inhibit the degree to which private initiatives can be actively encouraged. A continuation of this year's wage and price trends will require maintaining interest and corporate tax rates at a level still too high to permit an adequate base for rapid expansion of private investment. Moreover, purposive restraint of the rate of growth, which is necessary because of inflation, will also tend to dampen what Lord Keyes called "the animal spirits of investors." A slowdown in the advance of corporate profits and the demand for

20. Total losses to strikes of 12.1 million workdays in the first quarter of 1971 already exceeded those for all of 1970. Of the 12.1 million, some 9.5 million were lost to wage and working conditions disputes and some 2.6 million to political strikes against the industrial relations bill.

investment could not come at a less auspicious time. Rapid structural change and improvement in production techniques will be needed to meet the competition with Common Market manufacturers attendant on EC accession.

36. Although the British have recently enjoyed a respite from their near-perennial bouts in defense of sterling, one of the prime effects of sustained inflation will be a significant weakening in the balance of payments. 21/ As a consequence, they will probably have difficulty in covering the net balance-of-payments costs (for the medium term) of accession to the EC. This is likely to result in economic measures that would tend to restrain domestic investment and growth, thereby nullifying some of the potential gain from EC membership. To avoid this, the British government may be forced to devalue the pound prior to accession. As the lessons of 1967-68 clearly demonstrate, it is extremely important that the government break the prevalent inflationary psychology before any devaluation, or even this strong medicine will be quickly dissipated in another round of wage and price gains.

37. Because inflation acts as a continuing catalyst for dissension concerning government's role in guidance and management of the economy, it also threatens to erode the base of Conservative political support. With only very limited progress in slowing wage inflation in the public sector and no solid clues on the content of incomes policy in its mildly expansionary 1971 budget, the government is particularly vulnerable to the criticism that it is transferring the full responsibility for breaking the wage/price spiral to private-sector management. Proposals for effective alternatives – such as wage or price controls – involve a degree of intervention generally unacceptable and politically costly to the Conservatives. The slight relaxation of monetary restraints and the modest reduction of the corporate tax rate may sustain a brief honeymoon with private-sector management, but there will probably be growing anxiety on its part as arm-twisting – without guidelines – is increasingly invoked to

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21. The principal adverse impact of increasing relative costs and prices is on the trade account. As indicated in an earlier section of this memorandum, this is most strongly felt in terms of a reduction in export competitiveness and profitability. One indirect consequence of inflation that has proved favorable to the balance of payments has been the need to maintain high interest rates as one means of encouraging saving and restraining the expansion of credit. This resulted in large inflows of short-term capital in late 1970 and early 1971. Although the short-term movements indirectly facilitated debt repayment, they are a mixed blessing because: (1) they are volatile and could quickly reverse (to Britain's detriment); and (2) they tend to worsen domestic inflation.

hold down the inevitable price rises in 1971-72. Organized labor, which perceives any intervention by a Conservative government in the labor market as anathema, will likely become more militant in reaction both to broad government statements on the need for wage restraint and to the development of a new legal and institutional framework under the industrial relations bill. 22/ Although the growing popular acceptance of the industrial relations bill owes much to public resentment toward recent labor excesses, its passage in a period of inflation is complicated by the fact that related political strikes, by disrupting production, fuel further cost and price increases.

38. Another social conflict exacerbated by the present inflation is the question of appropriate income distribution within British society. The most apparent facet of this conflict is the battle between management and wage-earners, but the process of inflation also takes a toll among less-organized and less-vocal elements of society. The present rates of wage and price increases reinforce such trends as: (1) the transfer of real income away from the self-employed and those on fixed salaries or pensions; and (2) the transfer of real wealth away from savers. 23/ Indeed, the only real gainers in income redistribution in recent years have been those within organized labor, where support for the Conservative Party is classically thin. In contrast, the traditional supporters of the Conservatives were the relative income losers of the late 1960s. Just as this undoubtedly contributed to the cohesion of the party in the June 1970 electoral victory, failure to offset the steady redistribution of income shares toward organized labor will serve to undermine Conservative support.

Conclusions

39. The steady erosion of the political consensus underlying Labor's incomes policy resulted in money wage increases substantially greater than productivity gains after the 1967 devaluation. Poor timing and coordination of monetary and fiscal measures during 1968-69 meant lost opportunities to protect the improved international competitiveness and to lay the

22. An even more pointed conflict with the labor faction could develop over a recent government proposal to reduce the weekly social security compensation paid to families of some long-term strikers. Aggressive government action on this measure could be impeded by the need to minimize conflicts in an already volatile inflationary setting. It might prove easier and less contentious to pass such a measure if wage disputes and their related strikes were less numerous.

23. These tendencies have particular political importance in the United Kingdom, where a relatively larger share of the population is 65 or over than in all but a few other countries.

groundwork for solid real growth and productivity gains. A key – and unsuccessful – battle to pass an industrial relations bill in 1969 absorbed much of government's energies, wasted its remaining influence with labor leaders, and diverted its interest from the defense of the often-violated 3.5% target for annual wage gains. The result of these patterns was a rapid escalation in wage demands and settlements in 1969.

40. Perhaps already doomed because it was to be an election year, 1970 saw unusual highs in wage and price gains, losses of worktime to strikes, and unemployment levels. [redacted] 25X6

25X6 [redacted] Despite increasing monetary restraint and some stiffening of resistance to public-sector demands, the new government was unable to turn the tide before yearend; and fourth-quarter indexes for retail prices, wages, and earnings were up 7.7%, 13%, and 14%-15%, respectively, over the corresponding period in 1969. Although some progress was made in communicating to the private sector a sense of government resolve to hold the line against inflationary demands with which it was confronted, the conclusion of a contract for large wage gains by the Ford Motor Company and the announcement of a mildly reflationary budget that contained scant guidance on incomes policy seriously clouded the outlook for this year.

41. Even allowing for sustained government success in rallying corporate management against exorbitant wage increases, UK wages and retail prices will probably still rise close to 10% in 1971. The principal causes of this alarming outcome will be: (1) the need to increase product prices to cover earlier wage gains and adjustments to decimalization; (2) increasing costs of non-labor inputs such as raw materials and foods; and (3) the severe difficulty of breaking into the inflationary anticipations that keep initial wage demands high. In consequence, purposive reflation will remain very risky, and the economy will continue to grow at less than its potential. Moreover, the anticipated cost/price effects will drop British export competitiveness below the November 1967 level, an outcome likely to become quite evident in export earnings by yearend.

42. The principal longer term effect of continued inflation would be to inhibit seriously Conservative strategies to accelerate economic growth. The necessary stimulus to provide initiatives would be dampened by the requirement to avert any further impetus to wage and price gains. This comparative restraint would reduce the scope for expansion of domestic investment incidential to EC accession, and the inflation-related weakening of the balance of payments would also complicate the process of meeting the medium-term costs of Common Market entry. Because the adverse effects of relative wage and price rises are already in train, Britain may

be forced to devalue the pound before EC accession; but the experience of 1967-68 clearly indicates that it will be crucial to break the prevailing inflationary psychology beforehand if this measure is to have some lasting results.

25X6